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The Tax Consequences of Settlement Agreements

Elizabeth Erickson, Partner, McDermott Will & Emery, LLP, and Ira B. Mirsky, Partner, McDermott Will & Emery, LLP

Abstract

Employment-related disputes are a major business concern for many companies. These lawsuits are often brought by former employees and can include wage and hour claims (for missed rest breaks, overtime pay and off-the-clock work), discrimination and/or harassment claims, retaliation claims and wrongful termination claims. Claimed damages can include wage damages (such as lost wages, benefits and severance pay), nonwage damages (such as emotional distress, humiliation and injury to reputation), punitive damages, injunctive relief, statutory penalties, interest and attorneys' fees and costs. Companies periodically agree to settle these types of lawsuits and may enter into agreements to make payments to the claimants and/or their lawyers. The tax reporting of settlement payments can be quite complex, and companies making such payments should be aware of approaches to handle some of the most common issues that arise under these settlement agreements and be aware of the recent Internal Revenue Service guidance on handling these issues.

Keywords

employer, lawsuit, settlement, tax, payments

Determining Taxable Amounts

Articulating and Allocating Settlement Amounts

A company's settlement of a lawsuit should be articulated in a settlement agreement and reflect the company's analysis of its exposure should the claims proceed to trial. Best practices dictate that companies have a policy in place so that every settlement agreement explicitly states the purpose for all payments. For example, where appropriate, such a policy should designate specific amounts as payments in lieu of wages, damages, attorneys' fees and so forth.

A second useful recommendation is to have the settlement agreement approved by a court, when possible, in an effort to confirm that any allocation of amounts between multiple claims is reasonable. In the absence of such review, the Internal Revenue Service (IRS) sometimes argues that the claimant and the taxpayer that settles the claims "collude" to structure the settlement with the most favorable tax status (i.e., typically with very little allocation to wages). Review and approval by an independent third party will in many cases help negate any adverse inferences by the IRS.

If a company does not specifically articulate the purpose for each settlement payment in the settlement agreement, any allocation of amounts between multiple claims generally will be determined by reference to the underlying nature of the claims alleged, as well as to evidence of the parties' intent in settling those claims. *See, for example*, *S&B Restaurant v. Comm'r,* 73 T.C. 1226, 1232 (1980). After-the-fact allocations of lawsuit settlement payments are inherently more susceptible to challenge by the IRS but can be sustained in some cases where there is contemporaneous, extrinsic evidence supporting the allocation, such as attorney notes, settlement offers and counter offers or interrogatory responses.

Taxability of Settlement Payments

After payments are allocated to specific claims, the next step is to determine whether each type of settlement payment is taxable to the claimant. The determination of the taxability of the payments is important because the settling

Corresponding Author:
Elizabeth Erickson, McDermott Will & Emery, LLP, 600 13th Street, N.W., Washington, D.C., 20005, USA
Email: eerickson@mwe.com

company must file an information return (Form W-2 or Form 1099) for all amounts taxable to the claimant. It is crucial to note that, for settlements of the most common types of claimed damages in lawsuits brought by former employees, it is not unusual for the entire settlement amount to be taxable to the claimant.

Taxable payments. The general rule is that settlement amounts paid to a claimant are taxable to the claimant. *Carter v. Comm'r*, 298 F.2d 192, 194 (8th Cir. 1962); *Republic Automotive Parts v. Comm'r*, 68 T.C. 822, 823-24 (1977). This includes payments made to settle the following types of claims:

- Salary, wages, back pay, front pay, severance pay, overtime pay
- Benefits
- Penalties (unless paid to a governmental entity)[1]
- Punitive damages and double or treble damages
- Liquidated damages
- Compensatory damages
- Interest, including prejudgment interest and post-judgment interest
- Loss of enjoyment of life, shame, humiliation, anxiety, worry, loss of self-esteem, injury to reputation and emotional distress (unless accompanied by physical sickness)
- Attorneys' fees and costs

Nontaxable payments for physical injury. Internal Revenue Code section 104[2] provides a limited exception to taxability for certain selected payments made to a claimant in settlement of claims for a physical injury, including the following:

- Payments for personal physical injury or physical sickness
- Emotional distress (only when accompanied by physical sickness)
- Out of pocket medical expenses
- Attorneys' fees and costs associated with the recovery of nontaxable physical injury payments

Under Code section 104(a)(2), all damages (other than punitive damages) that flow from a personal physical injury or physical sickness are not taxable to the claimant, including amounts for lost wages/earnings that would otherwise be taxable but for the physical injury. As a result, it is not necessary in these cases to separately state how much of the award represents wages or other damages because no Form W-2 or Form 1099 will be issued to the claimant. Nevertheless, it will be necessary to issue a Form 1099 to the attorney if the check is written in a manner that gives the attorney the right to cash the check (as discussed in more detail below).[3]

Injunctive Relief

In some cases, a company may settle a lawsuit by agreeing to injunctive relief (i.e., agreeing to perform certain actions or agreeing to stop certain activities). In those cases, and assuming there are no other payments to the claimant, the claimant may not have any taxable income as a result of the settlement unless attorneys' fees are also paid. Here again, the payment of attorneys' fees may raise additional issues, as discussed below.

Attorneys' Fees and Costs

It is typical in most lawsuits filed against an employer or former employer for the claimant to request the reimbursement of attorneys' fees and costs. Accordingly, in settling lawsuits companies may specifically designate an amount to be paid as attorneys' fees. These fees may be paid to the claimant, to the lawyer or to the claimant and lawyer jointly. The taxation of attorneys' fees has generated much controversy but the general rule is that the payment of attorneys' fees is taxable *to the claimant* regardless of the type of fee arrangement (i.e., flat fee, hourly or contingent) and *even if the fees are not paid directly to the claimant.*

Attorneys' fees and costs are generally taxable to the claimant. As a general rule, attorneys' fees are taxable to the claimant, even if the claimant owes these amounts to another or the payment is made jointly or separately to the claimant and another person. Treas. Reg. § 1.6041-1(f). The Supreme Court has also specifically held that when a claimant recovers taxable damages and is obligated to pay contingent attorneys' fees, those fees are "as a general rule" included in the taxable income of the claimant.[4] *Comm'r v. Banks,* 543 U.S. 426, 430 (2005); Treas. Reg. § 1.6045-5(f), Examples 1, 3. This is consistent with the idea that when a payment is made to satisfy the obligation of a claimant to a third party, the amount of the payment is generally includible in the claimant's gross income. Even if claimants never actually receive such payments, they receive the benefit of the payment, and the amount is therefore gross income. *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 729-30 (1929).

Attorneys' fees associated with a physical injury. Just as there is a narrow exception to the general rule that settlement payments are taxable to the claimant unless they compensate the claimant for a physical injury, attorneys' fees and costs associated with the recovery of nontaxable physical injury payments also are not taxable to the claimant. Treas. Reg. § 1.6045-5(f), Example 2.

Attorneys' fees paid under a fee-shifting statute. The law regarding the taxability of attorneys' fees paid under a "fee-shifting" statute is not clear. The Supreme Court in *Banks* noted that cases involving fee-shifting statutes raise additional issues but declined to address them. 543 U.S. at 438-39. Some guidance in this area can be found in *Sinyard v. Commissioner*, 268 F.3d 756, 758 (9th Cir. 2001), *aff'g* T.C. Memo. 1998-364. In *Sinyard*, the Ninth Circuit affirmed the Tax Court in holding that statutory attorneys' fees awarded under the fee-shifting provision of the Age Discrimination in Employment Act in an "opt-in" class action suit were taxable to the claimant as income. In contrast, in *Flannery v. Prentice*, 28 P.3d 860, 871 (Sup. Ct. Cal. 2001), the Supreme Court of California examined whether an award made under the California Fair Employment and Housing Act, a fee-shifting statute, was the property of the client or the lawyer. Although not a tax case, the court found that, absent proof of an enforceable agreement to the contrary, the attorneys' fees belonged "to the attorneys who labored to earn them." Unfortunately, a recent memorandum from the IRS Office of Chief Counsel relating to employment-related settlement payments (discussed in more detail below) does not clarify the fee-shifting issue.

Because of the uncertainty in the law, the safest course for any company making a settlement agreement is to treat attorneys' fees awarded under fee-shifting statutes as taxable to the claimant under the general rule of inclusion.

Attorneys' fees paid in connection with injunctive relief. As with fee-shifting statutes, the Supreme Court in *Banks* noted that cases involving injunctive relief raise additional issues but declined to address them. 543 U.S. at 438-39. The recent memorandum from the IRS Office of Chief Counsel relating to employment-related settlement payments (referred to above and discussed in more detail below) also does not clarify the injunctive relief issue. Here again, with no clear authority on the tax treatment of any attorneys' fees paid under these circumstances, the safer course is for companies to treat these attorneys' fees as taxable to the claimant under the general rule of inclusion (unless another exception applies).

Claimant not liable for attorneys' fees. In rare circumstances where the claimant is not liable for the payment of attorneys' fees incurred in connection with employment litigation, it is possible that such a payment of attorneys' fees may not be includible in the gross income of the claimant. The rationale is that, in this case, the fees are actually expenses of another person or entity rather than expenses of the claimant receiving the judgment or settlement. An example of this type of case is seen in Rev. Rul. 80-364, 1980-2 C.B. 294 (Situation 3), where a union filed claims on behalf of its members against a company. Subsequently, the union and the company entered into a settlement agreement, later approved by a federal district court, that provided that the company would pay the union $40x dollars in full settlement of all claims. The union paid $6x dollars of the settlement for attorneys' fees and returned $34x dollars to the employees for back pay owed to them. The employees had to include in their gross income only the $34x they actually received and did not have to include any part of the $6x attorneys' fees. This was because the portion of the settlement paid by the union for attorneys' fees was a reimbursement for expenses incurred by the union.

Attorneys' fees in class actions. Applying the rationale in Rev. Rul. 80-364 to class action lawsuits, the IRS has ruled that legal fees paid directly to class counsel out of a settlement fund are not income to a taxpayer-class member if (a) the taxpayer-class member did not have a separate contingency fee arrangement or retainer agreement with the class counsel and (b) the litigation was an "opt-out" class action.[5] The IRS relied on the rationale in Rev. Rul. 80-364 that in this circumstance the class member is not liable for the attorneys' fees. P.L.R. 200625031 (Mar. 14, 2006).[6] This same reasoning was applied in *Eirhart v. Libbey-Owens-Ford Company,* 726 F. Supp. 700, 706-07 (N.D. Ill. 1989). Here, the court held that separately deposited funds paid to the "opt-out" class members' attorneys in settlement of class action claims arising under Title VII did not result in gross income to the class members.

Outside these specific factual circumstances, however, the safer course for companies making settlement agreements is to treat attorneys' fees paid in class action lawsuits as taxable to the claimant under the general rule of inclusion.

Deduction for attorneys' fees in certain limited cases. As part of settlement negotiations, it is useful for companies to know that the impact of including attorneys' fees in the income of claimants may be mitigated in some cases because Code Sections 62(a)(20) and 62(e) permit an "above-the-line" deduction for attorneys' fees incurred in connection with certain lawsuits. Specifically, Code Section 62(a)(20) permits individuals to deduct attorneys' fees paid for claims relating to (a) unlawful discrimination; (b) the enforcement of civil rights; (c) any provision of federal law prohibiting discharge, discrimination or other forms of retaliation or reprisal against an employee for asserting rights or taking actions permitted under federal law (popularly known as whistleblower protection provisions) or (d) any provision of federal, state or local law or common law claims permitted under federal, state or local law providing for the enforcement of civil rights; or regulating any aspect of the employment relationship, including claims for wages, compensation or benefits; or prohibiting the discharge of an employee, the discrimination

against an employee or any other form of retaliation or reprisal against an employee.[7]

This "above-the-line" deduction, while very broad, will not apply in every case. With respect to actions where the above-the-line deduction does not apply, taxpayers may be subject to tax with respect to a portion of any such attorneys' fees for which they cannot claim a deduction.

Reporting Taxable Amounts to Claimant

All payments in excess of $600 that are taxable to the claimant (including attorneys' fees) must be reported on either a Form W-2 or Form 1099. I.R.C. § 6041; Treas. Reg. § 1.6041-1(a). All taxable amounts are reportable to the claimant even if the payments are made to the claimant's attorney. Treas. Reg. § 1.6041-1(f); Treas. Reg. § 1.6045-5(f), Examples 1, 3. If a claimant receives only amounts that are nontaxable, no information reporting to the claimant is required. I.R.C. § 104(a)(2); Treas. Reg. § 1.6045-5(f), Example 2.

Form W-2 Reporting

All payments attributable to wage-related claims must be reported on a Form W-2 issued to the claimant. The company should issue a Form W-2 to the claimant for the total amount of all such payments, even if the check is issued directly to the claimant's attorney (or to the attorney and the claimant jointly), and even if a separate Form 1099 is issued to the claimant's attorney for some or all of the amount. Treas. Reg. § 1.6041-1(a), -1(f), -2; Treas. Reg. § 1.6045-5(f), Examples 1, 3.

Only payments attributable to wage claims are reportable on Form W-2. All other taxable payments are reportable on Form 1099. For example, both punitive damages and attorneys' fees are reportable on Form 1099, not Form W-2.[8]

Form 1099 Reporting

All taxable nonwage payments, such as punitive damages, liquidated damages, compensatory damages, payments for emotional distress, interest and attorneys' fees and legal costs associated with the recovery of taxable amounts, must be reported on a Form 1099 issued to the claimant. *See* General Instructions for Forms 1099, 1098, 5498, and W-2G (specifically listing attorneys' fees and punitive damages among the types of payments to be reported on Form 1099-MISC); Treas. Reg. §§ 1.6041-1(a)(1)(iii), -1(a)(2). Companies should issue a Form 1099 to the claimant for the total of all such payments, even if the check is issued directly to the claimant's attorney (or to the attorney and the claimant jointly) and even if a separate Form 1099 is issued to the claimant's attorney for some or all of the amount. Treas. Reg. § 1.6041-1(a), -1(f), -2; Treas. Reg. § 1.6045-5(f), Examples 1, 3.

In summary, the total amount reported on the Form W-2 issued to the claimant and the total amount reported on the Form 1099 issued to the claimant should equal the total amount of payments taxable to the claimant.

Reporting to Claimant's Attorney

General Requirements

Once a company determines its reporting obligations to the claimant, the company must also determine its reporting obligations to the claimant's attorney. Treas. Reg. § 1.6041-1(a)(1)(iii) states that:

> a person who, in the course of a trade or business, pays $600 of taxable damages to a claimant by paying that amount to the claimant's attorney is required to file an information return under Section 6041 with respect to the claimant, as well as another information return under Section 6045(f) with respect to the claimant's attorney.

The company should therefore issue a Form 1099[9] to the attorney *for the full amount of the check*, whenever the check is written in a manner that gives the attorney the right to cash the check. This applies even if the check is for more than just attorneys' fees and even if the entire amount or some of the amount is not taxable to the claimant. Treas. Reg. § 1.6045-5(f), Examples 1-3. In addition, these rules do not vary depending on the nature of the underlying lawsuit. Thus, if the attorney has the authority to cash the check, a Form 1099 must be issued to the attorney in the settlement of class action lawsuits, fee shifting cases, injunctive relief situations and so forth.

As a result of this rule, in some circumstances a company will be required to issue two Forms 1099 for the same amount—one to the claimant and one to the attorney. Therefore, the company might be required to issue Form 1099 for more than the total settlement amount. For example, in addition to the reporting requirements relating to the claimant:

- If the check is written only to the attorney, a Form 1099 must be issued to the attorney in the full amount. Treas. Reg. § 1.6045-5(a).
- If the check is written to both the attorney and the claimant, a Form 1099 must be issued to the attorney in the full amount. Treas. Reg. § 1.6045-5(f), Example 1.

- If the check is written to the attorney's client trust fund, a Form 1099 must be issued to the attorney in the full amount. Treas. Reg. § 1.6045-5(d)(4).

Specific Circumstances

The attorney is not a payee when the attorney's name is included on the payee line as "in care of," as, for example, a check written to "client, c/o attorney" or when the check is written in any other manner that does not give the attorney the right to negotiate the check. Treas. Reg. § 1.6045-5(d)(4). The attorney is also not a payee if the check is written only to the claimant but delivered to the attorney. Treas. Reg. § 1.6045-5(f), Example 4.

The attorney does not need a Form 1099 if the check is written only to the claimant—even if the settlement agreement designates part of the settlement amount as a payment for attorneys' fees or the claimant ends up paying the attorney a portion of the settlement amount. Treas. Reg. § 1.6045-5(f), Example 4.

If more than one attorney is listed as a payee on the check, settling companies should issue a Form 1099 to only the attorney to whom the check is delivered for the entire amount of the check. If the check is delivered to a nonpayee or a payee nonattorney, a Form 1099 must be filed by the company to the first-listed payee attorney on the check. That attorney (to whom the company issues the Form 1099) must then file Forms 1099 for any payments made to other payee attorneys. Treas. Reg. §§ 1.6045-5(b)(1) and (2); Treas. Reg. §1.6045-5(f), Example 5.

IRS Office of Chief Counsel Memorandum

As this discussion has shown, the complexities of tax issues in settlement payments are considerable. In an attempt to provide practical guidance on these issues, the IRS Office of Chief Counsel produced an internal memorandum dated October 22, 2008 (but released only in July 2009). *See* Office of Chief Counsel Internal Revenue Service Memorandum ("IRS Counsel Memorandum"), dated October 22, 2008, UILC: 61.00-00, 3101.00-00, 3111.00-00, 3402.00-00, *Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements.* The IRS Counsel Memorandum outlines both the income and employment tax consequences, as well as the appropriate reporting, of employment-related settlement payments and contains useful information for companies settling employment-related lawsuits.

The IRS Counsel Memorandum sets forth a four-step process for determining the correct treatment of employment-related settlement payments. First, the taxpayer should determine the character of the payment being made and the nature of the claim giving rise to the payment. Second, the taxpayer should determine whether the payment is taxable to the claimant (i.e., an item of gross income). Third, the taxpayer should determine whether the payment is wages. Fourth, the taxpayer should determine the appropriate tax reporting for the payment, whether it is on IRS Form 1099-MISC or Form W-2. The issues to consider in the four-step process have been discussed at length in this article.

Although helpful, the IRS Counsel Memorandum is not a comprehensive "one-stop-shopping guide" to determining the correct tax treatment of employment-related settlement payments. Notably absent is guidance relating to the following:

- The implications surrounding employment-related settlement payments for physical injury (since the IRS Counsel Memorandum presumes such payments are unlikely to exist)
- The implications of settling a lawsuit by agreeing to perform certain actions or agreeing to stop certain activities (i.e., injunctive relief)
- The implications surrounding class action lawsuits (including the payment of attorneys' fees)
- The implications of using qualified settlement funds in conjunction with making employment-related settlement payments

The IRS Counsel Memorandum also is not a well-balanced discussion of the authorities, because it fails to acknowledge the indications by the Supreme Court in *Banks* that attorneys' fees awarded pursuant to a fee-shifting statute might not be taxable to a claimant. The *Banks* decision leads to the practice point of clearly documenting either the allocation of a portion of a court-ordered judgment to statutory attorneys' fees or expressly documenting in the terms of a settlement agreement that an amount paid to the claimant's attorney was "in lieu of statutory fees."

In addition, the IRS Counsel Memorandum only superficially addresses the nuances surrounding the tax information reporting for attorneys' fees, particularly if a company is required to issue two Forms 1099-MISC (one to the claimant and one to the attorney), or if it is required to issue Forms 1099-MISC totaling more than the amount of the judgment or settlement actually received by the claimant. Finally, the Memorandum offers no definitive help in resolving the unclear issues when a judgment or settlement payment includes multiple elements, each of which may or may not be wages.

It is uncertain whether the IRS will issue future clarification on these issues. However, employers who may develop their own guidelines for dealing with settlement tax issues should continue to be alert for any changes in IRS positions on the issues discussed here, particularly the volatile issue of attorneys' fees. Given the likelihood that the number of employment-related lawsuits will continue to increase (the U.S. Equal Employment Opportunity Commission reported that in 2008 it received more than 95,000 claims alleging discrimination for age, race, religion, gender or other reasons, up 15% from the year before and the most since the agency was formed in 1965), it seems reasonable to suppose that new matters arising in litigation will require future agency clarification on tax issues.

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Notes

1. If, as part of a settlement, a company makes a payment of fines or penalties to a governmental entity, those payments will not be taxable income to the claimant. In addition, such payments may not be deductible by the company. I.R.C. § 162(f); Treas. Reg. § 1.162-21(b)(1)(iii).
2. Code references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.
3. Code section 104(a)(2) excludes from gross income the amount of damages received (whether by suit or agreement) on account of physical injury or sickness. The current regulations under section 104(a)(2) (and controlling guidance at the time that both the IRS memorandum and this article were written) explain that "damages received (whether by suit or agreement)" generally means an amount received through a legal judgment or award "based upon tort or tort type rights," or a settlement agreement in lieu of such a lawsuit. Treas. Reg. § 1.104-1(c). On September 15, 2009, the IRS proposed amendments to the regulations that would eliminate the so-called tort type rights test, so that damages received for physical injuries may qualify for the exclusion from gross income under Section 104(a)(2), even though the nature of the injury or the scope of remedies available under state or common law are not defined as a tort. REG-127270-06.—Fed. Reg. Vol. 74, No. 177, p. 47152 (September 15, 2009).
4. Although attorney fees may be taxable income to the claimant (and reportable on a Form 1099), they are not wages and are not subject to FICA/Medicare tax withholding. Rev. Rul. 80-364, 1980-2 C.B. 294.
5. In "opt out" class action lawsuits, potential class members generally do not need to take any action to be considered part of the class. A class member does, however, have the right and power to affirmatively exclude himself from the class.
6. Because attorney fees paid under the specific fact pattern described above will not be income to the class members, companies will not have reporting requirements to the class members for these fees. However, such companies should issue a Form 1099 to class counsel if the check is written in a manner that gives the class counsel the right to cash the check.
7. *See* I.R.C. §§ 62(a)(20), 62(e) for a complete list of enumerated claims.
8. *See* Rev. Rul. 80-364, 1980-2 C.B. 294.
9. All information reporting to a claimant's attorney is made on Form 1099. The company should not issue a Form W-2 to the claimant's attorney, even if part of the settlement is for wage-related claims. *See generally* the Code and Regulations under §§ 6041 and 6045.

Bios

Elizabeth Erickson is a partner in the Tax Department of McDermott Will & Emery LLP's Washington, D.C., office. She focuses on tax controversies, including tax litigation, with significant experience in disputes before the U.S. Tax Court, U.S. District Courts, the Internal Revenue Service Appeals and Examination Divisions and the Internal Revenue Service National Office.

Ira B. Mirsky is a partner in the Employee Benefits Department of McDermott Will & Emery LLP's Washington, D.C., office. He focuses on tax controversy matters related to employee compensation, fringe and welfare benefits, deferred compensation arrangements and employment tax and information reporting issues in general.